Public economics after neoliberalism: A theoretical-historical perspective

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Abstract

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Keywords

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Abstract

Musgravean public economics, as the dominant public policy framework of the post-WWII era, argued that the government can and should supplement the price mechanism in order to create a social order within which a democratic society can flourish. Starting with the late 1970s, this project of public economics has been challenged by the growing dominance of neoliberalism as a form of governmentality that extends the economic logic of markets into the domain of the state and its mode of exercising sovereignty over its subjects. After outlining the historical and the disciplinary context of this challenge, the article maintains that endogenous theoretical confrontations internal to public economics should also be taken into consideration to provide a fuller account of the eclipse of the Musgravean public economics in the era of neoliberalism.

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1. Introduction

Since the 1980s, neoliberalism has been replacing social democracy as the dominant platform for economic and social policy in all capitalist social formations. We understand neoliberalism not simply as the extension of the rule of the market and the limitation of the state, but rather as a radical reconfiguration of the relationship between the state and the market. In stark contrast to the social democratic project that uses the state apparatus to limit the excesses of the price mechanism and protect the social body from the turbulence of capitalism, neoliberalism aims to transform the state and its mode of exercising sovereignty by modelling it on the logic of 'economic incentives'.

Public economics, the field of economics that studies the relationship between the state and the market, has been profoundly affected by this political, economic and cultural transformation. Nevertheless, we should equally acknowledge that theoretical developments endogenous to the discipline of economics have caused important changes in the core theoretical propositions and policy prescriptions of public economics. Moreover, these shifts and dislocations have, in turn, contributed to the rise of neoliberalism by performatively enacting an economisation of the language of institutional governance and reform in a wide range of social sites such as health care, education, defence, research and development, security, cultural production.

In this paper, we argue that three emerging areas of theoretical concern and confrontation have been crucial in shaping the development of public economics: namely, the increasingly systematic use of the assumption of opportunism (read as manipulability) in public economics when modelling all social behaviour, including those of bureaucrats; the growing recognition in social choice theory of the irreducible normativity of choice among

various methods to aggregate exogenously-determined individual preferences into social choice functions; and finally, the shift in the meaning of 'good society' due to a proliferation of individualist challenges to the presumed fairness of the redistributionary implications of the post-WWII general equilibrium theory. We argue that these theoretical developments internal to public economics should be read as both *in the context of* and *as the context of* the transition from social democracy to neoliberalism. These developments are not simply effects resulting from the trajectories of post-war neoclassicism (and hence the rise of neoliberalism); they constitute the terrain on which theoretical battles were fought and won.

In studying the transformation of public economics from post-war Keynesianism to neoliberalism, we aim to recover and revitalize the original and founding project of Musgravean public economics; namely, using the government to limit the excesses and turbulences of the market economy and embed the economy back into the democratic control of the public. The fact that the world is currently going through the deepest economic recession since the Great Depression makes this reappraisal all the more necessary and urgent. In this spirit, in Section 2 below, we begin by revisiting the basic contours of Musgravean public economics and situate it in the context of post-war social democracy. Section 3 introduces Foucault's analysis of neoliberalism as a form of governmentality and offers a definition of neoliberalism by distinguishing it from *both* classical liberalism *and* the post-war social-democratic project (as manifested notably in European welfare states and American 'New Deal' liberalism). In Section 4, we focus on the discipline of economics in order to outline the post-war trajectories of neoclassicism as a context of developments in public economics. In Section 5, we concentrate on public economics and the three areas of theoretical confrontation. The concluding section briefly assesses the current state of public economics, draws lessons

from the recent history of the field and offers a conceptual framework for the renewal of public economics in the twenty-first century.

2. Public economics for a democratic society

Public economics, as a distinct and core field of the discipline of economics, has matured and gained widespread prominence, in the aftermath of WWII, when neoclassical-Keynesian synthesis and general equilibrium theory dominated mainstream economics (Backhouse 2002). The government's leadership role in the war effort and the immediate urgency of re-building the infrastructures of war-torn economies, the second fundamental theorem of welfare economics and its implications for redistributionary politics (which itself was associated with the Socialist Calculation Debate of the late 1930s), the paternalism of the welfare state and the success of Keynesian counter-cyclical macroeconomic policies all contributed to the growing theoretical sophistication, policy expertise and social legitimacy of public economics. In this period, public economics was concerned not only with the correction of various market failures (such as public goods, externalities, imperfect competition, cyclical imbalances), but also more explicitly with normative questions ranging from the fairness of redistributionary transfer payment schemes (theories of justice) to the properties of various preference aggregation mechanisms (theories of social choice) (Drèze 1995).

Accordingly, modern public economics, following a path of maturation from Arthur Pigou to Richard Musgrave, embraced the government as an institution that can and should supplement the price mechanism in order to enact a framework within which a democratic society can flourish (Musgrave 1986, 1987). It is in this broad philosophical orientation and in clear contrast to Austrian economists' conservative disdain for human design and belief in the virtues of a *spontaneous order* (Hayek, 1988; see also Caldwell 2004), and Chicago

economists' axiomatic belief in the indisputable superiority of the market as a *selection mechanism* (Alchian 1950: 217; Becker 1962: 10; Friedman 1953: 22ff), that modern public economics defines its central theoretical and normative concerns as a body of knowledge that aims to '*re-embed* the economy' (to use Karl Polanyi's (2001 [1944]) trope; see also the *Foreword* by J. Stiglitz and the *Introduction* by F. Block) by supplementing and, if necessary, limiting the economic logic of the price mechanism. It is important to note, however, that this normative project of public economics was structured around a theoretical apparatus based on the assumption that individuals behave opportunistically. Indeed, we argue that the retreat of public economics under neoliberalism cannot be adequately accounted for without appreciating endogenous theoretical developments generated by this underlying assumption.

Starting with the early 1970s, this configuration lost steam. A large number of socio-political, geo-political, economic and even technological factors contributed to this shift from a social-democratic New Deal liberalism to a global Thatcher-Reagan style neoliberalism, where (a narrowly defined) efficiency trumps fairness, market failures are preferred to government failures, public ownership is considered a vice, unabashed individualism is celebrated and society is declared to be non-existent (Brown 2003; Duménil and Lévy 2004; Harvey 2005). While it is impossible to give a comprehensive account of this historical passage in the confines of this paper, it is important to highlight that the conclusion of the cheap oil era in the mid-1970s made it impossible for advanced capitalist social formations to continue on the high-wage, high-growth path of the post-war New Deal regime of accumulation without compromising the profitability of the capitalist corporations (Mitchell 2009). Similarly, the increasing volume of international trade and capital flows (if only initially among the nation-states of the global North), facilitated by technological developments, made it possible for the emergent transnational capitalist classes to successfully solicit governmental support to

enhance competitiveness by deregulating labour and capital markets and reducing corporate taxes (Sklair 1998).

While the democratically-sanctioned project of post-war public economics became 'concerned with welfare and redistribution because people [were]' (Kolm 1987: 1049), under the emergent neoliberalism, this very idea of protecting the social body through deliberate governmental action to limit and contain the excesses and failures of the market economy came under attack, and its legitimacy quickly eroded in the shifting ideological environment. With the advent of the language of economic incentives and given the new consensus pertaining to information failures, efficiency enhancement was reduced to marketisation (the transition from Pigouvian taxes to Coasean marketable permits in the quest to control externalities being a paradigmatic example); with the decimation of built-in stabilizers and fiscal policy tools, the only technique available for stabilisation became tax cuts and counter-cyclical monetary policy; and the provision of merit goods and the redistribution of income and wealth were deemed ideologically and politically illegitimate (Harvey 2005; Wolff 2009).[1]

Nevertheless, this transformation did not entail the disappearance of the state but rather manifested itself in the transformation of how the state exercises its sovereignty according to the logic of 'economic incentives'. In this paper, we argue that this 'economic' mode of governmentality has some of its intellectual roots in the theoretical developments internal to public economics and its broader theoretical context, the discipline of economics. Accordingly, we also argue that it is impossible to understand the erosion of the legitimacy of the

[1] Today, the stimulus package the Obama Administration prepared for 2009-2010 in response to the worst economic recession since the Great Depression inevitably heavily relies on government spending, despite a huge budget deficit inherited from the previous administration (Feldstein 2009); nevertheless, its underlying philosophy considers fiscal policy (the provision of public goods, entitlements, *et cetera*) simply as an instrument of economic efficiency and stabilisation rather than a social right.

liberal/social democratic project and the 'economisation' of the state without taking into account a number of theoretical transformations that occurred in the second half of the twentieth century including, *inter alia*, the growing criticisms launched against the general equilibrium approach, the impossibility theorems in social choice theory, the naturalisation of the market mechanism by Beckerian and Coasean perspectives and the emergence of agency-theoretic, asymmetric-information-based models. However, before giving a fuller account of the broader disciplinary context of the transformation of public economics under neoliberalism, we will introduce Foucault's reading and analysis of the key texts of the Chicago economists in his quest to define neoliberalism as a (biopolitical) form of governmentality and weave the implications of his analysis into our own reading of the trajectories of post-war neoclassicism and public economics.

3. Neoliberalism as a form of governmentality

Although neoliberalism is closely associated with an anti-totalitarian Hayekian suspicion for all forms of deliberate interventionism and rational design (Hayek 1988), the practical, worldwide success of the proponents of the neoliberal project can only be understood through their strategic use of the state as a tool for implementing 'marketisation' policies (such as privatisation, financial liberalisation, trade liberalisation, deregulation, rolling back of the welfare state). David Harvey (2005: 2), for instance, emphasises the role played by the state in creating and preserving the neoliberal institutional framework, which he defines as 'strong private property rights, free markets, and free trade'. More starkly, Naomi Klein (2008) provides a detailed *exposé* of the implementation of neoliberalism throughout the developing world by military regimes with the active collaboration of the 'Chicago Boys'. In this sense, while the conservative 'classical' liberalism of the Austrian School supplied the ideological backbone of an individualist revolt against the paternalism of the welfare state, it was the

pragmatist economists of the Chicago School, experts in deregulation and privatisation, which led the take-over and transformation of the state apparatus.[2] In other words, neoliberalism, far from limiting its scope, used the state rather proactively.

Nevertheless, neoliberalism entails more than mobilising the state to implement 'marketisation'; it is a form of *governmentality* that entails the 'economisation' of the social. In a 1978 lecture, Michel Foucault (1991 [1978]: 102) defined governmentality as an ensemble formed by 'the institutions, procedures, analyses, calculations and tactics that allow the exercise of [a] complex form of power' over the social that facilitates the materialisation, maintenance and reproduction of the economic processes of production and distribution and the political processes of sovereignty and order-making. Accordingly, contrary to earlier classical liberalism that sought to isolate the market from state interventions, neoliberalism as a form of governmentality is 'a whole complex of *savoirs*' (p. 103) that seeks to govern the social by generalising the logic of economic incentives throughout the state apparatus and promoting its extension to the entire social domain.[3] According to Foucault's analysis, the

[2] For a history of the Chicago School that situates the tradition in the broader context of post-war neoclassicism, see Mirowski (2002) and van Horn and Mirowski (2005). For informative interviews with prominent members of the Chicago School, including Friedman, Stigler and Coase, see Breit and Spencer (1995).

[3] Foucault develops his analyses of neoliberalism in his recently translated lectures on classical liberals, German ordo-liberals, Hayek and Chicago economists. There are a number of possible reasons that might have led Foucault to writings by Chicago economists such as Schultz, Stigler, Becker. To begin with, the study of the intellectual sources of emergent neoliberalism is a continuation of his work on the changing forms of 'governmentality'. He refers particularly to the emergence of French neoliberalism as represented in some of the formulations of Giscard d'Estaing as early as 1972. According to d'Estaing, Foucault explains, it is necessary to 'decouple' the efficiency-enhancing functions of public policy from its redistributionary-and-social-justice-focused functions and it is this conceptual decoupling that signifies the break from the social democratic consensus of post-war France (pp. 194-207). Second, as the editor of *Lectures* Michel Senellerat notes (p. 234), Foucault responds to and draws upon the French reception of American neoliberalism (Henri LePage's interpretations of Chicago economists figure prominently). And finally, the topics studied by Chicago economists (e.g., crime, human capital, addiction, individual irrationality and market rationality) correspond to concrete

subject of the neoliberal state is not the citizen-subject of (social) rights, but rather the economic subject as represented in the figure of *homo economicus*, a rational opportunistic individual who 'is sensitive to modifications in the variables of the environment and [who] responds to this in a non-random way, in a systematic way' (p. 269). Foucault notes that Chicago economists do not necessarily conceive *homo economicus* as a 'realistic' representation of the 'truth' of the economic subject, but rather as a working assumption for theoretical modelling, policymaking and institutional reform.[4] In the useful terminology of semiotics, the concept of *homo economicus* is not 'constative', but rather 'performative, that is, actively engaged in the constitution of the reality that [it describes]' (Callon 2007: 318).

Neoliberal governmentality, as a complex ensemble of *savoirs*, institutions and *dispositifs* that endow economics with its 'performative' power, aims nothing less than to re-institute and shape the social by using this founding theoretical construct of neoclassicism as 'the interface of the government and individual' (Foucault 2008 [1978/1979]: 253). Indeed, recent literature on the 'performativity of economics' suggests that this 'economisation' of the social has the potential to transform social subjectivity (Callon 1998, 2007). Once the institutional environment is reconfigured and the assumption of *homo economicus* becomes the 'the grid of intelligibility' through which the state exerts its power over its citizen-subjects, the latter are compelled to behave like *homo economicus* (Brown 2003; Lemke 2001).

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contexts in which 'the rationalization of the exercise of government' with 'the internal rule of maximum economy' (p. 318) can be and since then have been enacted. For a fuller account of the historical and intellectual context of these lectures and their place in Foucault's broader research project, see Gordon (1991) and Lemke (2001).

[4] In particular, see Alchian (1950), Becker (1962) and Friedman (1953); for surveys of these 'selectionist' papers, see Loasby (1999), Madra (2007) and Vromen (1995). Foucault's (2008 [1978-79]: 252-3) formulation is also worth quoting: '[C]onsidering the subject as *homo economicus* does not imply an anthropological identification of any behavior whatsoever with economic behavior. It simply means that economic behavior is the grid of intelligibility one will adopt on the behavior of a new individual.'

Unfortunately, Foucault's reading of modern economic theory is limited to writings by proponents of the Chicago School. Yet if we were to coax Foucault's definition of neoliberalism (qua the 'economisation' of the social) to its logical conclusions, we would need to acknowledge that the post-war general equilibrium approach and its various correlates (such as new Keynesian macroeconomics, new information economics, mechanism design approach) also belong to the epistemic horizon of the neoliberal creed. These post-Walrasian, new Keynesian economists continue to operate within the symbolic universe of neoliberal governmentality so long as they insist on taking the 'competitive model' as 'the norm' (Arrow 1963a: 941), as an optimal state to be approximated, and theorise the key economic problem as the opportunism of economic agents (under uncertainty). Nevertheless, many proponents of the post-Walrasian approach strongly disagree with Chicago-style neoclassicals; the former insist that information failures are 'endemic' and cannot be remedied with new markets (Arrow 1963a; Stiglitz 1994: 12), while the latter argue that all failures (including information) are due to transaction costs and could be resolved by more markets.

In this sense, what makes Foucault's analysis valuable and powerful also happens to be its blind spot. We can only understand the internal dynamics of neoliberal era, if we study not only the commonalities but also the differences between the Chicagoan and post-Walrasian approaches; and we can only account for the emergence of New Labour in England, Neue Mitte in Germany and the New Democrats in the US in the 1990s, if we recognize their intellectual roots in post-Walrasian arguments. Although the actual practice is almost always diluted, with the rise of neoliberalism, the language of economic incentives (with all its normative baggage) rather than social rights and entitlements came to dominate social policy debates between the left and the right on matters concerning the tax system, minimum wage, social security, health care, immigration, trade, environment, *et cetera*. In the next section, we

focus on an analysis of the trajectories of post-war neoclassicism and its correlate Austrian tradition with the aim of providing an account of the internal theoretical dynamics of neoliberal creed.

4. Trajectories of post-war neoclassicism

In understanding the trajectories of post-war neoclassicism in the North American context, it is necessary to distinguish between at least two skeins of neoclassical tradition; namely, the general equilibrium approach articulated around the Cowles Commission and the selectionist Marshallianism of the Chicago School (Madra 2007; Mirowski 2002).[5] The Cowles Commission was populated mostly by left-leaning European *émigrés* such as Oskar Lange, Tjalling Koopmans, Leonid Hurwicz and Gérard Debreu, who were well-versed in mathematical formalism. Along with Kenneth Arrow, it is also possible to place Paul Samuelson within the orbit of a theoretical centre configured around the Cowles Commission (Arrow 1991; see also interviews with Klein, Arrow and Samuelson in Breit and Spencer 1995 and Debreu in Weintraub 2002). On the other end of the political spectrum, at the University of Chicago, a rival theoretical centre began to form around Milton Friedman, George Stigler, Gary Becker and Ronald Coase. While it is impossible to consider Friedrich von Hayek intellectually as a part of the Chicago School, he was definitely an ideological ally and instrumental in forging a long-lasting relation between the Volker Fund and the faculty of the University of Chicago (Caldwell 2004; van Horn and Mirowksi 2005).[6] In contrast to the Walrasianism of the Cowles Commission, this skein of neoclassicism found its theoretical

[5] The theoretical mapping and historical narrative outlined in this section is based upon an analytical differentiation of the field and therefore inevitably abstracts from a number of otherwise pertinent nuances and complexities.

[6] Similarly, while the Virginia School of public choice, to be explored below, bears a strong family resemblance to the Chicago School, it would be erroneous to disregard their important differences—especially in the context of regulation theory (Orchard and Stretton 1997; Zenginobuz 1995).

origins in the market equilibrium analyses of the Marshallian tradition. The Chicago approach distanced itself from the abstract formalism of general equilibrium models and chose to focus on applied econometric studies of individual markets (Breit and Spencer 1995). Furthermore, rather than conceiving the economy as a system of individual excess demand functions, it drew upon selection metaphors and spoke about representative firms and market demand functions (Alchian 1950; Becker 1962; Friedman 1953; see also Madra 2007).

Early on, the dazzling speed with which affiliates of Cowles Commission formalized the Walrasian vision, the power of the neoclassical-Keynesian synthesis in providing the macroeconomic policy framework and the developments in social choice theory, placed the general equilibrium approach at the apex of the discipline. Nevertheless, by the 1970s, many commentators had conveniently latched onto the Sonnenschein-Mantel-Debreu results as a demonstration of the impossibility of the micro-foundations project at the then-desired level of generality, and even proponents of the theory were acknowledging the limits of the general equilibrium framework (Kirman 1992; Rizvi 1994; for a dissenting account, see Katzner 2006). Famously, Frank Hahn (1984: 52) noted that the Arrow-Debreu equilibrium is not a description of an actual economic system, but a theoretical construct that helps the economist 'to show why the economy cannot be in this state'. In other words, for Cowles economists like Arrow, Debreu and Hahn, the general equilibrium model was tantamount to a theoretical proof of the impossibility of the invisible hand theorem. Once this 'negative role' of the Arrow-Debreu model became acknowledged, the Cowles-MIT skein of neoclassicism turned its attention to market failures, information asymmetries, game theory and agency-theoretic approaches. By the 1980s, the formalism of general equilibrium theory was replaced by the formalism of game theory and incomplete markets. An important aspect of this theoretical turn was the growing prominence of the assumption of opportunistic behaviour (Bowles and Gintis

1993). In other words, the Cowles-MIT people moved from the parametric information environment of the general equilibrium theory to the strategic information environment of game theory.

As a result, new research fields and theoretical orientations began to shape what can be termed as the post-Walrasian condition in late neoclassical economics: New Keynesian economics applied the ideas of moral hazard and adverse selection to factor markets and tried to develop micro-foundations for (what they deemed to be) the key Keynesian insight pertaining to non-clearing equilibrium outcomes (Shapiro and Stiglitz 1984); new information economics expanded the same ideas to product markets (Stiglitz 1994); game theoretic analyses of oligopolistic collusion, tax evasion, voluntary provision of public goods, social conflicts and all kinds of coordination problems became commonplace. Baptised by its key investigator Arrow (1963b) as the 'aggregation problem', the question of summing up independent agents' preferences at the social level turned out to have many game theoretical applications under the existence of informational asymmetries as well. While at first this wide range of applications and new avenues may seem to constitute a varied and heterogeneous field, all these analyses were essentially grounded in the behavioural assumption of strategic opportunism and the widespread existence of information asymmetries (Stiglitz 1993). The title of one of the more methodologically-sophisticated reflections on the post-Walrasian turn in this skein of neoclassical economics aptly summarized the process: 'The Revenge of *Homo Economicus*' (Bowles and Gintis 1993).

The first major theoretical confrontation between the Cowles Commission and the Chicago School occurred in the field of macroeconomics. Once the Philips Curve, illustrating a trade-off relation between inflation and unemployment (hence providing an empirical justification for anti-cyclical fiscal policy), broke down in the stagflationary context of the oil

shocks, the monetarism of Friedman emerged as the new theoretical framework and policy platform (Tabb 1999: 163-71). The concept of a non-accelerating inflation rate of unemployment, combined with the crowding-out arguments against fiscal policy, reduced the macroeconomic policy palette to anti-inflationary monetary tools. In stark contrast to the new Keynesian emphasis on information problems and the concept of bounded rationality introduced by behavioural economists (Simon 1959), new classical economists argued for calibrating monetary policy with macroeconomic models based on the rational-expectations assumption (Lucas and Sargent 1981; Muth 1961; for an epistemologically-sophisticated critique of the rational expectations hypothesis, see Bausor 1983).

At the microeconomic level, the Chicago School confronted the post-Walrasian models of imperfect information with models of market failure that were based on transaction costs. Unlike post-Walrasian models of imperfect information, where the remedy was based on designing manipulation-proof mechanisms, Chicago economists argued that the solution to market failures stemming from transaction costs was to introduce new markets. Here, they referred to the Coase Theorem (1960), according to which market failures occur either because property rights are not fully delineated, or because there are transactions costs, or both. This marketisation drive was further augmented by Becker's (1976) economic approach to human behaviour, where constrained utility maximisation provides the universal framework to understand *all* kinds of human behaviour, ranging from political processes to the allocation of resources within the household.

Underlying this Beckerian universalisation of economic behaviour was a selectionist understanding of market processes. In the early 1950s, in a series of papers, a number of Chicago economists constructed an alternative conceptualisation of the invisible hand theorem (Alchian 1950; Becker 1962; Friedman 1953). Rather than relying on the Walrasian

Auctioneer, they used the Marshallian representative-agent construct to argue that, even if each agent did not behave according to the marginal calculus, the average representative firm or household would still behave consistently with neoclassical theory (Kirman 1992). While each economist articulated this in slightly different ways, they all argued that the competitive forces would function like a selection mechanism and lead the market towards an equilibrating adjustment at the aggregate level. This selectionist argument not only quickly replaced the auctioneer metaphor as the core neoclassical narrativisation of the invisible hand theorem, but also became (in Becker's hands) a meta-framework applicable to all social phenomena (Fine 1999).

And finally, the coincidence of the rejuvenation of the Austrian School in the 1980s and the emergence of the neoliberal discourse should not come as a surprise, as at the policy level the Austrians were quite influential in promoting a 'free-market' economic system in the post-war era (suffice it to recall the role Hayek played in organizing the highly-influential Mont Pèlerin Society).[7] But the Austrians' intervention was certainly above and beyond the political domain; they forced post-Walrasian economists first to revisit the Calculation Debate, where Hayek, following von Mises' opening salvo in 1922, battled fiercely with Walrasian socialists in the late 1930s, and later to reopen a set of interrelated methodological questions pertaining to the discipline itself, by unpacking the core concepts of 'market equilibrium', 'knowledge' and 'entrepreneurial discovery' (Hayek 1935, 1948; Kirzner 1973, 1997; for contemporary assessments, see Adaman and Devine 1996, 2002; Caldwell 1997). With its emphasis on the spontaneous organizing power of the price mechanism, mediated through the

[7] In passing let us note that Hayek's writings on cultural evolution (1988) have also contributed to the turn towards evolutionary arguments in mainstream economics. If Becker's 1962 article is one of the most important points of reference for contemporary evolutionary game theory, the other is Hayek's writings on cultural evolution and spontaneous order (Samuelson 2002; Sugden 1989).

entrepreneurial articulation of tacit knowledge, the Austrian School acknowledged the complexity of subjective human choices and thus almost categorically rejected any mathematical modelling of a dynamic, competitive, non-equilibrating and evolving market process. Despite their clear separation from the Chicago School on methodological matters at least at the level of public discourse, both criticized the social democratic project, emphasized the role of economic incentives and favoured property-rights solutions to many economic problems (Skousen 2005).

To conclude, let us examine the three broadly defined schools of thought (post-Walrasian, Chicago and Austrian) in their relation to our definition of neoliberalism as the form of governmentality through the interface of *homo economicus*. First, while all the approaches discussed above rely on a version of the *homo economicus* postulate, none of them would go so far as to argue that *homo economicus* accurately represents the nature of the human subject. In this sense, the different variants of selectionism found in the writings of Alchian (1950), Friedman (1953) and Becker (1962) offer valuable insights into the logic of neoliberalism. According to these models, although no one behaves precisely like *homo economicus*, as long as the conditions of scarcity, or competition, or both prevail, social outcomes would not only be consistent with predictions of the standard neoclassical model, but also be economically efficient and hence desirable (from the perspective of utility maximising 'representative' agents). Therefore, regardless of how individual actors behave, the Chicago approach insists on implementing marketisation reforms and transforming economic and social institutions (as in the case of vouchers for school choice) in a manner that elicits *homo economicus*-like behaviour (for an application of this approach to financial markets, see Fama 1998). This is not a unique feature of the Chicago approach, however. The post-Walrasian agency-theoretic approaches also base their economic analyses and policy prescriptions on the

assumption that all individuals behave opportunistically (Myerson 2009). As we will argue more carefully below, because they aim to achieve economic efficiency solely by designing manipulation-proof institutions, post-Walrasian public economists have also, albeit inadvertently, contributed to the neoliberal transformation of the state. An interesting and perhaps unexpected implication of our definition of neoliberalism pertains to the position of the Austrian School. Its proponents, while subscribing to a notion of purposeful and rational individual action as their foundational premise, resist employing the formalism of rational actor models and are critical in their approach to the narrowly defined notion of *homo economicus*—bringing them close to the classical liberal position which aims to isolate the market from the state (Caldwell 2004).[8] Nevertheless, recognition of this point does not change the fact that many Austrian economists, and in particular Hayek, played important roles (both by legitimating the movement ideologically and by networking politicians, corporate actors and economists) in the neoliberal counter-revolution (van Horn and Mirowski 2005).

5. Theoretical confrontations within public economics

The historical transition from social democratic consensus to neoliberalism in the 1980s, and the trajectories of mainstream economics in the post-war era, certainly had a profound impact on both the theory and practice of public economics. In our contemporary late-neoclassical context, modern public economics can at best be described as an eclectic bricolage of the Pigou-Musgrave tradition, the Chicago-cum-Austrian marketisation approach and the agency-theoretic mechanism-design literature. In part due to this eclecticism, we argue that modern public economics suffers from a set of unsettled problems—problems that are potentially

[8] In his 1962 rejoinder, Israel Kirzner criticized Becker's claim about the dispensability of the rationality postulate as a description of individual behaviour, and argued that the notion of purposeful and rational individual behaviour (but not the narrowly defined notion of *homo economicus*) was necessary for economic theory.

difficult to settle because they emanate from three distinct yet interconnected theoretical developments endogenous to traditional public economics.

The first and perhaps most important theoretical confrontation pertains to the motivations of bureaucrats that would design and implement efficiency-enhancing institutional supplements to markets: If bureaucrats are also prone to engage in manipulative behaviour, then who will design and implement the corrective policies? The second theoretical impasse concerns the choice of non-market mechanisms of preference aggregation: Since there is no manipulation-proof aggregation method, the choice of method itself becomes a contested terrain (both normatively and politically speaking) that cannot be resolved through the expert-knowledge of bureaucrats. And finally, the third development is the erosion of post-war consensus on the meaning of 'good society' due to a proliferation of individualist challenges to the presumed fairness of the redistributionary implications of the post-war general equilibrium theory.

We argue that all these, primarily endogenous, theoretical developments contributed to the diminished legitimacy of the social project of traditional public economics. While the agency problem undermined the social legitimacy of the bureaucrat, the aggregation problem exposed the inherent normativity that structures the very enterprise of public economics. The developments in the philosophical field, on the other hand, demonstrated that there is no uncontested notion of 'good society' that can be relied on. In the remainder of this paper, we aim to make sense of the current state of modern public economics by organizing its internal theoretical confrontations and impasses around these three problems.

The agency problem

The standard theory of regulation is based on the assumption that disinterested expert-bureaucrats implement corrective mechanisms in the name of a 'public good'. As Ünal Zenginobuz (1995: 30) notes, the two key underlying assumptions here are that 'there is a well defined (definable) "general good", "public interest", and that the government is the neutral servant of this "general good"' (see also Florenzano 2009).

The capture theories of regulation that were first articulated in the late 1970s took issue with these assumptions (Haid 2001). A version of capture theory articulated by economists of the Chicago School claimed that the opportunistic behaviour of government officials, when faced with the demands of competing interest groups, will nonetheless reflect the efficient arbitration of these interests (Stigler 1988). The Virginia School of public choice, however, insisted that the political market place would not be as efficient as the economic market. In particular, James Buchanan and Gordon Tullock's work (1962) brought about the much-celebrated concept of 'government failure' to denote situations where government intervention causes more inefficient allocation of goods and resources than would occur without it.

It is important to underscore, however, that this twist introduced by the capture theories of regulation was indeed a logical consequence of the ontological presuppositions of traditional public economics and a correction of the theoretical inconsistency that characterized the public interest theory of regulation. For this reason, the post-Walrasian literature on the design and implementation of incentive-compatible mechanisms to evade manipulation and opportunistic behaviour (in collecting taxes, in setting out regulations, *et cetera*) began to ask the question raised by capture theories of regulation: But who will guard the guardians? (Hurwicz 2008).

This universalisation of the opportunism assumption in the theory and practice of public economics reflected itself in endless cost-benefit analyses that comparatively assess inefficiencies under market failures and government failures. Within this framework, a Sisyphean structure was set in such a way that it became impossible to arrive at that 'final' design which would domesticate or harness the opportunism of individual subjects (whether they be citizens or bureaucrats), and the demand to design and implement manipulation-proof institutions is perpetually renewed. In this sense, the Sisyphean structure of the agency problem is the theoretical engine of the development of neoliberalism as a form of governmentality.

The aggregation problem

The 'problem' here pertains to the aggregation of the exogenously-determined preferences of individual subjects (who are assumed, as always, to be opportunistic) in a manner that enables social reconciliation without any friction. Social choice theory, different in its concerns and methodologies from the Virginia School, takes the question of aggregation seriously because its objective is to formulate the conditions necessary for a 'legitimate' definition of the 'general good', an a 'reasonable' image of the 'good society'.

There are in fact two impossibility theorems which continue to retain their foundational status. The first one is Arrow's (1963b) pronouncement (and later refinements by Gibbard 1973 and Satterthwaite 1975—see also Reny 2001) that for an *a-priori* set of axioms (deemed by Arrow to be a 'reasonable set' in the context of liberal democracies), which should be satisfied by every reasonable aggregation rule, inconsistency and manipulation are indeed inescapable. The second is Amartya Sen's (1970, 2002) finding that it is impossible to be committed to both liberalism and Pareto optimality. Although much of subsequent research

was devoted to the variations of these axioms (Saari 2001), with an aim at transforming impossibilities into possibilities, the challenge remains pending.[9] But more importantly, the proliferation of the possible set of axioms itself reveals the inherent normativity of the aggregation problem.

Let us take a closer look at this to locate this deeper, more structural aggregation problem. Normativity of the impossibility theorems implies that we always need to make a choice among different aggregation methods. But, to choose an aggregation method (or the choice of a reasonable *a priori* set of axioms), we need to use a particular method of aggregation (or sets of axioms)—then which method of aggregation should be used to choose among different methods of aggregation? This problem is structural and should not be treated simply as a logical infinite regress problem that can be solved within a general-equilibrium framework through a 'fixed-point theorem'. Nor will it help to leave the choice of the aggregation method to the experts—because, if so, we would be back to square one, to the 'agency' problem and to the Virginia critiques of 'rent-seeking' bureaucracy. Given the foundational presuppositions of the social choice field pertaining to the behaviour of individuals (that they are opportunistic) and the nature of the preferences (that they are exogenous), there is no way to solve the aggregation problem as a technical one from within the theoretical apparatus of the field. In this sense, the problem points at the impossibility to ground the social order in universally-agreed-upon foundations and the necessity of that moment of 'leap of faith' at the very core of the democratic legitimacy.

[9] Let us note in passing that allowing interpersonal comparability of utilities will undoubtedly ease the aggregation problem. Nevertheless, this would itself necessitate a new aggregation problem of deciding on the definition of comparability.

Let us be clear. This 'deeper' aggregation problem is only a problem from within the individualist, contractual political ontology that also informs neoliberal theory and practice. To begin with, citizens are assumed to be capable of and willing to manipulate the aggregation procedure.[10] Second, citizens' preferences are assumed to be unalterable and exogenously given, and therefore, by design, attempts to create public discussions and interactive social processes and to facilitate institutional frameworks that aim to achieve social co-operation through persuasion, compromise and commitment on (key) policy issues are left outside of the solution set.

A much more radically-individualistic solution to problems of a social nature, such as the provision of public goods and services, that aims to by-pass the government and the bureaucrats as much as possible, is through letting individuals effectively reveal their preferences over public goods and services by 'voting with their feet'. Here the reference is Charles Tiebout's (1956) well-known set up, where citizens, who are offered a menu of jurisdictions providing different types and levels of public goods and services, will (rationally) choose the very community which would supply the mix they prefer the best—thus ensuring efficiency (Bloch and Zenginobuz 2006; Fischel 2006).[11] The Tiebout model is based on a set of severe assumptions, viz. perfect residential mobility, no spill-over of benefits and costs across jurisdictions and immunity requirement against coalitional deviations. The severity of this set of assumptions should not distract us from the implications of this vision of the social: Tiebout can achieve his aim only by eradicating the public sphere itself. To make sure that

[10] While it is indeed true that the growing literature on behavioural economics and evolutionary game theory entertains the possibility of a wide variety of behavioural orientations, *homo economicus* continues to be the behavioural template that dominates policy making. For a critical survey of behavioural economics, see Adaman and Madra (2002).

[11] Another similar formulation is offered by Buchanan (1965) in his 'club theory', where he explores the aspects of providing excludable and partially non-rival public goods.

there is competition among jurisdictions (each providing a different mix of public goods and services), a society surely needs a large amount of these goods and services, thus partitioning the public into too many small pieces—the aggregation problem is indeed solved by simply abating the social fabric.[12]

It is possible to map the contrast between (i) the desire to find a 'fair' aggregation method to give a socially-legitimate point of reference to 'guardians' and (ii) the desire to solve the problem by partitioning society into micro-jurisdictions or affinity clubs, onto the contrast between (i) post-Walrasian mechanism design and (ii) the Chicago-Austria-Virginia marketisation skeins of the neoliberal theoretical horizon. The traces of this contrast are reflected once again at the level of philosophical debates on the nature of 'good society'.

The 'good society' problem

The origins of the 'good society' problem in the modern sense can be traced all the way back to the 1930s, to the ordinalist turn in welfare economics. Even though the theoretical conditions that made ordinalism possible were already laid down with the marginalist revolution (Cooter and Rappoport 1984), Benthamite utilitarianism remained an important reference point until the 1930s. Bentham's hedonistic calculus of pain and pleasure was premised on the idea that a cardinal index, a common denominator to compare, add and subtract the utility magnitudes of different individuals, existed. In fact, for utilitarianism, a 'good society' would be one that maximises the total utility of the community.

[12] An alternative interpretation of Tiebout would be to imagine a 'small-is-beautiful' world. Although we welcome decentralisation and localisation efforts as steps towards a self-governing society, we nevertheless underscore the utmost importance of cultivating links among localities however geographically and politically independent from each other they may be—thus contradicting the very basic assumption of the model.

Nevertheless, this premise (and utility theory in general) not only drew fierce criticism from American institutionalists such as Thorstein Veblen (1998 [1898]), but also violated the liberal political sentiments of many early neoclassical economists (Mandler 1999). According to many interwar neoclassical economists, the imposition of a cardinal metric implied the imposition of a particular substantive notion of what is 'good' for society as a whole (Lewin 1996).[13]

After the ordinalist turn, and in particular after Arrow's 'post-cardinalist' impossibility theorem, the second Fundamental Theorem of Welfare, which implies that 'any [Pareto] optimal state is a competitive equilibrium corresponding to some [initial] distribution of purchasing power' (Arrow 1963a: 943), became the theoretical cornerstone for redistributionary policies of the post-war welfare state. Nevertheless, by the 1960s, the critics were already beginning to articulate their dissent and objections to this post-war ordinalist welfarism and its implications for redistributionary policies. Already in his *The Road to Serfdom,* Hayek (1944) had been warning the public about the perils of extending the government's role in the economy and arguing for the superiority of spontaneous order and cultural evolution (of property rights, in particular) over institutions of human design. Similarly, we should read Buchanan and Tullock's (1962) constitutionalist framework as a system designed to minimize 'government failures' by limiting its scope to the protection of property rights.

[13] In passing, let us note that early Marshallian economists such as Pigou and Edwin Cannan, while distancing themselves from the Benthamite notion of utility and by extension from issues pertaining to the measurability of utility, continued to subscribe to a notion of interpersonal comparability of 'material welfare' (defined pragmatically in terms of access to 'necessaries' such as food, clothing and shelter; see Cooter and Rappoport 1984). According to these 'material welfare' economists, redistribution of the 'national product' from the rich to the poor, by permitting more material wants to be satisfied, would increase total welfare. Underlying this idea was a substantive notion of common 'good', namely the notion that the satisfaction of more material wants is good for everyone.

A very influential left-liberal formulation of how to arrive at a 'feasible' and 'desirable' just society that takes the equal distribution of 'primary goods' as the very basic (*equality*) principle of social order was offered by John Rawls (1971, 1996: 180-1): the only desirable and feasible social order (the 'good society') that would be chosen by equally rational and equally ignorant (about the positions they will eventually occupy in the resulting social order) individuals would be a liberal democratic society where citizens would agree upon a political conception of justice. For this purpose, the Rawlsian theory of justice supplements *the equality principle* (articulated above) with a second principle that permits social and economic inequality only to improve the welfare of the least advantaged. Perhaps, not surprisingly, the concrete set of institutions that would satisfy *the difference principle* was 'the organs of a welfare state' (Pettit and Kukkathas 1990: 51).

Nevertheless, Rawls' Kantian attempt to create a reasonably broad basis for social co-operation was rejected by proceduralist libertarians like Robert Nozick (1974), who argued that rights are natural, fundamental and absolute in the sense that their satisfaction should be conceived as a good in itself. For Nozick, any form of taxation regardless of its objectives involves a violation of the basic rights of the ownership of themselves and the fruits of their talents. Within this 'procedural' framework, there could be only minimal room for the state—to protect the rights of and to adjudicate conflicts among the contracting parties.

Even though Sen's (2002) rights-based capability approach did provide a new lease of life for left-liberals to continue thinking about issues of justice from within the choice-theoretic framework, by the end of the twentieth century, the post-war consensus on what counts as a 'just' method with which societies can decide on whether and how to implement redistribution, stabilisation and the provision of merit goods left itself into a split between the justice-as-fairness and the proceduralist-constitutionalist camps. This fragmentation, without doubt,

should be read in the context of the Sisyphean opposition between market and government failures (the agency problem), as well as the contrast between the aggregation of preferences and the disaggregation of the public sphere (the aggregation problem). In fact, in a conjuncture where public servants have lost the social legitimacy that they once enjoyed (they are not only deemed prone to manipulate the policy implementation process, but also lack a manipulation-proof aggregation method which would give them a clear mandate to implement the socially-chosen set of policies), it is not surprising that this loss of consensus on the nature of 'good society' has further weakened the constitutive project of public economics.

6. Public economics beyond neoliberalism

In this paper, we argued that a pre-condition of any critical engagement with the trajectories of public economics in the post-war era requires the study of internal theoretical developments by nesting them not only in the broader disciplinary context of the post-war neoclassicism (and its correlates), but also in the broader historical context of the rise of neoliberalism as a form of governmentality. We believe that this is definitely an opportune moment to revitalise and rethink the social project of public economics, namely the undertaking of deliberate governmental action to limit and contain negative social consequences of human economic activities, and reconfigure the economy as a means to end (sustenance of livelihood) rather than an end in itself. This is indeed predicated on our willingness to revisit and reconsider the three basic postulates of traditional public economics that paved the way to the endogenously-generated theoretical impasses in the first place: a strict adherence to individualism, the foundational behavioural postulate of universal opportunism, and the modernist idea of engineering social reconciliation through expert knowledge.

To further concretize our position, let us consider how public economics *beyond* neoliberalism can approach to the problem of global warming. Beginning with the 1990s, the carbon markets began to emerge as the main policy tool of neoliberal governmentality in mitigating global warming: first a 'cap'—a maximum allowable aggregate total quantity of emissions—is set; then, the permits are distributed to polluters (via grandfathering, auction, *et cetera*); and finally everything is left to the 'price' mechanism to ensure the reduction be achieved efficiently (Tietenberg and Johnstone 2004). With added layers (such as 'emissions permit banking'), the commodification of the environment (a commons) is completed. As it is necessary to quantify the climate benefits and costs in monetary terms, the cap-and-trade method requires the valuation of climate based on individuals' subjective preferences (given the available information on the climate problem and mitigation methods) as well as the choice of a discount factor as all future benefits and costs are to be expressed in a common term so as to determine the optimum 'cap'. Furthermore, the carbon markets run parallel to a system of carbon offsets; instead of cutting emissions themselves, economic units (companies, governments and individuals, financial institutions, *et cetera*) finance 'emissions-saving projects' outside the capped area to generate carbon credits that can equally be traded within the carbon market.

We argue that public economics needs to move *beyond* neoliberalism, because 'economisation', when applied indiscriminately, as it is in the case of carbon markets, is likely to bring unwarranted consequences. Carbon markets, far from addressing the inefficiencies of opportunistic and manipulative behaviour, solicit manipulation, predatory behaviour and rent seeking, rendering themselves vulnerable to bubbles and crashes (Lohmann 2010a, 2010b; MacKenzie 2007, 2009). In other words, these market solutions subject a commons such as the global climate into the economic logic of markets and 'performatively' turn it into an object of

strategic-calculative logic. Similarly, the reduction of 'climate valuation' into a mere aggregation of individual subjective valuations may be inappropriate for such complex and uncertain phenomena as global warming, where individuals' valuations will have clear implications over others (both today and in the future) and other creatures. Indeed, in making decisions with substantial consequences pertaining our future (such as the overall growth rate, technological path, consumption habits and intergenerational justice), the market response may be substantially different from the ones that we may arrive at through collective deliberation and negotiation (Lohmann 2010a, 2010b; Schellnhuber 2006).

An important point of departure is to reconsider, therefore, the ways in which the individual figures in our contemporary economic analyses. In discussing the agency problem above, we argued that the neoliberal conception of the individual qua consumer imposes severe limits on the scope of government intervention to the economy. In contrast, the conceptualization of the individual as a citizen-subject, as a member of various communities, we argue, has the potentiality to broaden the horizon of the discipline in general and public economics in particular. Concomitantly, instead of assuming economic subjects as endowed with a pre-given behavioural orientation, we believe that an outlook that acknowledges the role that social structures play in shaping, forming and constituting individuals in a myriad ways is a condition of deeper appreciation of the social, political and economic aspects of life as an ensemble (see, for instance, Adaman and Madra 2002; Gibson-Graham 2006; Heinzerling and Ackerman 2007; Sagoff 1998; Tsakalotos 2005).

Without doubt, public economics cannot afford to be *naïve* about the manipulative capacities of neither individuals nor institutions (for instance, corporations). Therefore, the importance of rule-setting and design of proper incentive structures are not to be underestimated. Yet, at the same time, the field should also recognize the performativity of its

enunciations and policy prescriptions (Callon 1998): economic institutions designed solely to guard themselves from opportunistic behaviour tend to cultivate opportunistic behaviour. A more careful and self-reflective approach is therefore warranted, an approach that would acknowledge the importance of material incentives without forgetting that reducing everything into a mere incentive problem will very likely bring about a Sisyphean infinite regress of manipulation and counter-measures. To counter this, one objective of public economics *beyond* neoliberalism could be to develop theories and methods of governance to address the unique problems of commons (such as global climate) in a participative, deliberative manner and in multiple spatial-scales (local, regional and global). In this regard, Elinor Ostrom's (1990) institutionalist solution to collective-action problems, precisely because it ventures beyond the state-market dichotomy and takes contextualised institutional inventions of actors themselves seriously, constitutes a valuable point of departure for rethinking public policy. Nevertheless, we believe that a deeper transformation of public economics requires a much more thoroughgoing critical perspective towards the individualistic ontology of neoclassicism.

Such a perspective will also enable us to approach the aggregation problem discussed above from a different perspective. More precisely, consensus-building among individuals who embrace different views and approaches may be achieved via deliberative social mechanisms that aim to facilitate interactive debates and negotiations among individuals as well as institutional actors—a process through which values are learned rather than revealed, and a more embedded analysis of the political, social and institutional framework can be developed (see, for instance, Adaman et al. 2007; Devine 1988; Jacobs 1997). Such a deliberation will certainly have an additional value in cases where the society has to decide on issues that involve complexities (say, which method we should be relying on electricity production) and that are loaded with multifarious interfaces among societal, economic and ecological systems

(say, how much electricity we should be producing)—in brief in situations where an integrated, multi-scale and trans-disciplinary approach is deemed more appropriate (see, for instance, Munda 2008). To the extent that we rely on deliberative mechanisms, more will we be immune from the aggregation impasse.

In *The Great Transformation*, Polanyi (2001 [1944]) warned that instituting economics as a distinct system with its own laws of motion would sever the complexly-interwoven links among the social, the natural and the economic, and cause the lattermost to dominate both society and nature. The logic of neoliberal governmentality, whether in its marketisation or mechanism-design mode, does precisely this by reconfiguring the state-society relationship through the interface of *homo economicus* (see also various contributions to Harvey et al. 2007). Perhaps the deeper question is the way in which public economics and its practitioners position themselves in relation to the public itself. The modernist idea of engineering social reconciliation through expert knowledge may have played a very important role in leading public economics to its theoretical impasses and lack of social legitimacy. What if the aim of public economics is not to seek ready-made answers to engineer social reconciliation, but rather to design and enact innovative institutions to facilitate the participatory self-governance of communities? In the latter case, it may be quite possible for public economics to fully immerse itself in the project of socially embedding the economy through cultivating solidarity and civic responsibility, while diffusing the question of opportunism in the sociality, and rendering transparency and accountability more operational and meaningful. In this paper, we aimed to open up a conceptual space to render such paths visible.

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